

## **A New Business Strategy for the Changing Tobacco Industry: RJ Reynolds and Brown & Williamson Corp. Merge into Reynolds American Inc.**

Reynolds American Inc. (RAI) is now the parent company of RJ Reynolds Tobacco (RJRT) Company and Brown & Williamson Tobacco Corp. (B&W) after the two officially merged on July 30, 2004. British American Tobacco, the former owner of B&W, will indirectly own 42% of RAI stock while former RJRT shareholders will own 58%. Interestingly, the executives from both of the merged companies will integrate into one board of directors, with Susan Ivey, the former CEO of B&W, acting as executive chairperson.<sup>1</sup>

The causes behind this move are multiple and complex. Domestic demand for cigarettes (and other types of tobacco) has declined dramatically in the past decade due to the serious health risks made public through high profile lawsuits and anti-smoking campaigns. Second, whereas some companies could combat domestic decline by increasing their international production, RJRT happened to be very quiet on the global front after selling its international production rights to Japan Tobacco in 2001. Domestically, RJRT faces competition both from large companies and from small startups. Finally, in the past few years, many states have hiked up excise tax rates on cigarettes. RJRT cannot easily pass on this increase to consumers due to the decline in demand and competition from other companies. Lower profits result in cost cutting in important areas like marketing. Instead of accepting the loss of market share and profits, RJRT decided to pursue aggressive internal restructuring as well as the aforementioned merger with B&W.<sup>2</sup>

How will the formation of Reynolds American Inc. fight the problems that the companies were facing? First, investor confidence should be strengthened through an improvement in financial indicators. Experts in the financial arena believe that RAI's dividend and stock price will both increase due to the cost cutting the merger will allow.<sup>3</sup> Greater economies of scale will come about with the larger location. Bonnie Herzog, an analyst at Smith Barney, says, "This merger creates a financially stronger and more rational No. 2 competitor in the U.S. and should generate more free-cash flow due to substantial cost savings of at least \$500 million."<sup>4</sup> For example, Reynolds American Inc. will be able to promote its strongest brands effectively while decreasing emphasis on its cheaper brands. This will decrease the total amount of cigarettes purchased but it will raise profits overall. Because fewer cigarettes will be sold, RAI will pay less in Master Settlement costs, saving even more money.<sup>5</sup>

So far, Reynolds American has been a success. Initial predictions have proven more than correct; RAI's stock has risen 15.3% in 2004. Another even more telling statistic is that, while in the third quarter of '03 RJRT reported a loss of \$3.5 billion, the third quarter of this year notched a gain for RAI of \$339 million (with hundreds of millions more possible if the company can resolve some tax matters).<sup>6</sup>

The effects of the merger on the industry are also of interest. Tobacco analyst Martin Feldman does not believe that the effect on other companies in the industry will be substantial. Reynolds American will not significantly influence the growth of deep discount brands because it has decided to promote its more expensive brands. The success of the discount producers depends largely on the economy, which dictates what consumers are willing to afford. Feldman also believes the merger will not lead the emergence of new brands, which are extremely costly to

create, no matter the size of the company. However, he does hint that RAI will now have a much better chance at gaining on Philip Morris, especially in the menthol cigarette business. This indicates a pattern of oligopolistic competition in the tobacco industry whereby the top few companies operate based on the actions of the other top companies, while smaller companies hold a different niche from the larger firms.<sup>7</sup>

For workers and retailers, the merger is not a positive development. To exacerbate RJRT's *pre*-merger restructuring goal of cutting its workforce by 40%, Reynolds American decided to close B&W's Macon, Georgia and Louisville, Kentucky plants, causing massive layoffs. Only a small minority of those employees will be able to move to the consolidated operations site of Winston-Salem. Not surprisingly, local governments from Macon and Louisville lobbied vociferously against the merger to the Federal Antitrust Division. RAI will confront retailers, such as convenience stores, from a stronger position, especially in the short run. Because RJRT and B&W are now a single entity, fewer companies will control more of the retailers' business. This new relationship improves the bargaining position of the merged cigarette company.

Retailers may reap some benefits. For example, retailers will have one less contract to negotiate, and bidding wars between the top two companies have the potential to help retailers through the battle for store "real estate" like countertops, back displays, and shelves for marketing purposes.

To date, the merger has had positive effects for RAI, such as assisting its internal restructuring project, and providing greater economies of scale, higher stock prices and value per share, and increased profitability potential. At the same time, their merger has had little impact on the industry as a whole, though this will in large part depend on how the battle with Philip Morris transpires. The deal does not bode well for the former two companies' workforces, as most are sure to lose their jobs.<sup>8</sup> As with many other industries, the major companies in this industry control the product brands. As for workers, it is likely this consolidation will also lead to a price squeeze on lower segments of the supply chain, such as on the farming component.

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<sup>1</sup> RJ Reynolds Tobacco. R.J. Reynolds Tobacco Corporate Web Site, various pages. [Downloaded 1 December 2004]. Available at: <http://www.rjrt.com>.

<sup>2</sup> Eidam, Michael. "RJR: Seeing Through the Smoke." *Business Week Online*. 28 July 2004. Ebsco Host Research Database. Accessed 29 Nov. 2004.

<sup>3</sup> *Ibid.*, p. 2.

<sup>4</sup> *Ibid.*, p. 2.

<sup>5</sup> Laracy, Alex. "Retailers Divided as New Tobacco Giant Emerges," *Convenience Store News*, 13 Sep. 2004. Ebsco Host Research Database. Accessed 29 Nov. 2004.

<sup>6</sup> Louis, Brian. "Reynolds American posts profit of \$399 million in quarter," *Knight Ridder Tribune Business News*, 26 Oct. 2004. Proquest. Accessed 29 Nov. 2004.

<sup>7</sup> *National Petroleum News*. "Martin Feldman: a tobacco industry analyst, Merrill Lynch. RJReynolds was combined with the U.S. business of Brown & Williamson Tobacco Corp. On July 20, becoming a wholly owned unit of Reynolds American." September 2004. Lexis Nexis. Accessed 29 Nov. November 2004.

<sup>8</sup> Laracy (fn. 5); and *National Petroleum News* (fn. 7).